



Mozambique

mobilizing extractive
resources for development



Mozambique: Extractives for Prosperity, Volume II

Capstone Report: School of International and Public Affairs

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Abbreviations

ADIA	Abu Dhabi Investment Authority
AICD	Africa Infrastructure Country Diagnostic
ANE	Administração Nacional de Estradas
ARTC	Australian Rail Track Corporation
ASM	Artisanal and Small-scale Mining
AT	Administrative Tribunal
BAGC	Beira Agricultural Growth Corridor
BBOP	Biodiversity and Business Offset Program
BSEE	Bureau of Safety and Environment Enforcement
BTU (MMBtu)	British Thermal Unit (Million BTUs)
CCEP	Central Public Ethics Commission
CEDAW	Convention on the Elimination of all Forms of Discrimination Against Women
CEP	Central Ethics Commission
CESUL	Projeto Regional de Transporte de Energia Centro-Sul
CFM	Caminhos de Ferro de Moçambique
CLIN	Corredor Logístico Integrado do Norte
CoM	Council of Ministers
CONDES	National Council for Sustainable Development
CRC	Convention of the Rights of the Child
CRVP	Commission for Receipt and Verification
DMP	Government of Western Australia Department of Mines and Petroleum
DNAC	National Directorate for Conservation Areas
DNM	The National Director of Mines
DOI	Department of Interior
EDM	Electricidade de Moçambique
EFC	Estrada de Ferro Carajás
EFVM	Estrada de Ferro Vitória a Minas
EIA	Environmental Impact Assessments
EITI	Extractive Industry Transparency Initiative
EMIS	Environmental Management and Information Systems
ENH	Empresa Nacional de Hidrocarbonetos (National Hydrocarbon Company)
EPCC	Exploration and Production Concession Contract
ESI	Estimated Sustainable Income
eSISTAFE	electronic State Financial Administration System
EU	European Union
FDI	Foreign Direct Investment
FPSO	Floating Production Storage and Offloading Vessels
FUNAE	Fundo de Energia
GAP	The World Bank's Gender Action Plan
GAPP	Generally Accepted Principals and Practices
GCCC	Central Office for Combating Corruption
GCPV	Central Victim Protection Office
GDP	Gross Domestic Product
GGFR	Global Gas Flaring Reduction partnership
GTL	Gas-to-Liquids
G 19	Group of 19 Partners for Program Aid
HCB	Hidroeletrica de Cahora Bassa
HDI	Human Development Index

HVCC	Hunter Valley Coal Chain
ICCPR	International Covenant on Civil and Political Rights
ICSID	International Centre for the Settlement of Investment Disputes
ICT	Information and Communication Technology
IEA	International Energy Agency
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IGF	Inspector-General of Finance
IIED	The International Institute for Environment and Development
ILO	International Labor Organization
IMF	International Monetary Fund
INP	Instituto Nacional de Petroleo (National Petroleum Institute)
IOC	International Oil Company
IPEC	International Programme on the Elimination of Child Labour
IRR	Internal Rate of Return
IUCN	International Union for the Conservation of Nature
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
MCE	Maputaland Centre of Endemism
MDGs	Millennium Development Goals
MICOA	Ministry of Coordination of Environmental Affairs of Mozambique
MINAG	Ministry of Agriculture
MIREM	Ministry of Mineral Resources of Mozambique
MML	Minas Moatize Limitada
Model EPCC	Model Exploration and Production Concession Contract
MoF	Ministry of Finance
MP	Members of Parliament or National Assembly Deputies
Mtpa	Million-tons-per-annum
NBSAP	National Biodiversity Strategies and Action Plans
NEMP	National Environmental Management Plan
ODAMOZ	Overseas Development Assistance (Database) for Mozambique
ODI	Overseas Development Institute
OECD	Organization for Economic Cooperation and Development
OHCHR	UN Office of the High Commissioner for Human Rights
PAH	Polycyclic, aromatic and hydrocarbons
PARP	Republic of Mozambique Poverty Reduction Action Plan 2011-2014
PCI	Pulverized Coal Injection
PFCC	Petroleum Fund Consultative Council
POM	President of the Republic of Mozambique
PSSA	Particular Sensitive Sea Areas
PSC	Production Sharing Contract
SASOL	South Africa Synthetic Oil Liquid
SAIEA	Southern African Institute for Environmental Assessment
SEA	Strategic Environment Assessment
SIDA	Swedish International Development Cooperation Agency
SME	Small-and-Medium-sized Enterprise
SOE	State-Owned Enterprise
SPA	Sales and Purchase Agreement
SWF	Sovereign Wealth Fund
Tcf	Trillion cubic feet
UNCLOS	United Nations Convention On the Law of the Sea
WHO	The World Health Organization
WWF	World Wildlife Fund

Executive Summary

The development of Mozambique's significant mineral and hydrocarbon reserves has the potential to generate substantial wealth and prosperity for the country. The magnitude of possible benefits for Mozambique has powerful implications for one of the poorest nations in the world. It is up to the Government, and the people of Mozambique, to decide when, where, and, most importantly, how to utilize their reserves over the next few decades. Fundamentally, Mozambique is confronted with several challenges to transform its abundant extractive resource wealth – residing primarily in the country's inland coal deposits and its deep-water natural gas basins – into sustained, long-term economic development. This is a task of significant but not insurmountable complexity, encompassing a range of political, economic, and social dimensions. It will require collaborative and coordinated efforts by a variety of different stakeholders, some with conflicting objectives and priorities. It is thus incumbent upon Mozambique's leadership to manage this transition with purpose and develop and implement an industrial strategy that mobilizes the country's extractive resource development in a manner that achieves a prosperous outcome for its people.

Expectations of stakeholders are high, and this will not be an easy undertaking for the Government and people of Mozambique. Over the last five decades, numerous countries across the developing world have failed to benefit from their natural resource wealth. In fact, pervasive evidence suggests that resource-rich developing states tend to have lower economic growth rates and poorer development outcomes compared to states lacking such resources. Due to these paradoxical trends, collectively referred to as the resource curse, there is a renewed international focus on resource-rich, low-income countries like Mozambique.

This report provides a comprehensive review of the critical economic, political, legal, social, and environmental variables that will affect and be affected by the rapid development of Mozambique's extractive resources. Each section proposes methodical and practical recommendations for the country's policymakers, which – if implemented – will enhance the current institutional framework governing the activities of the extractive sector. Ultimately, this report attempts to provide the Government of Mozambique with a policy framework that promotes the sustainable development of the country's economy, society, and environment, and aims to help the country avoid the perils of the resource curse. These issues are described in greater detail in the summaries of each section of the report that follow.

Economic and Commercial

Mozambique stands to gain significant revenue from exploiting the economic and commercial potential of its natural gas and coal reserves. The country's offshore natural gas discoveries are among the largest finds in the world in over a decade, while its coal reserves are beginning to be exported to international markets. If it is able to successfully commercialize its extractive resources, Mozambique will become a highly competitive player on the global energy scene.

In addition to promoting economic growth, the Government's overall economic objective is to reduce persistently high rates of poverty. Currently eight out of ten Mozambicans continue to live on less than \$2 per day. In the years ahead, natural resource revenues will comprise an increasing share of the country's GDP, a trend that exposes Mozambique to several challenges in maintaining financial and social stability. Despite ongoing reforms, the country's overall capacity to absorb windfall revenues from the development of extractive resources remains

limited. Yet, with sound fiscal management, these hurdles can be overcome. There are a number of measures the Government can take to better prepare itself for the windfall. Prior to exploring such measures, however, it is first important to understand key implications of the resource curse and how it threatens Mozambique.

Generally, there are two underlying features of the resource curse that afflict countries: “Dutch Disease” and revenue volatility. Dutch Disease refers to the destabilizing impact of increased foreign exchange that inevitably follows a sharp rise in natural resource exports. A huge increase in natural resource revenues typically causes the real exchange rate to appreciate. The change in real exchange rate results in economic destabilization by reducing the international competitiveness of a country’s non-extractive resource exports (e.g. agricultural and manufacturing) and may also reduce employment in these sectors. These economic outcomes tend to adversely affect the labor force of a developing country, where undereducated workers often struggle to transition from traditionally low-skilled sectors of the economy to more knowledge-based and service-oriented industries.

Revenue volatility is another important facet of the resource curse. The disruptive effects of revenue volatility in a resource-based economy predominantly arise from fluctuations in global commodity prices. This volatility can be detrimental to growing economies and frequently results in imprudent fiscal policies. Often, governments borrow against the value of their newfound resources and spend windfalls on immediate consumption, at the expense of long-term investments that can hinder future growth opportunities for the country.

The resource curse commonly takes hold in developing nations that lack the institutional capacity necessary to manage huge resource revenues. To minimize the impacts of Dutch Disease and revenue volatility, a state must have sound institutions in place. Institutions are also necessary to manage complex public-private revenue-sharing partnerships that are typical of extractive industries. A sovereign wealth fund is one option that states can utilize to manage large inflows of resource revenue, stabilize pressures on the exchange rate, and reduce the influences of price and revenue volatility. The implementation of this fund (explained further below) is one of the central recommendations of this report. Above all, a sovereign wealth fund allows Mozambique to invest in infrastructure and socioeconomic development over the long-term, thus ensuring that the country will still see benefits of its extractive resources long after the reserves have been depleted.

Linkages and Local Content

Mozambique’s national resource wealth is not limited to revenue generation for the state but can and must flow to benefit local Mozambicans. Conventional understanding about how the local population benefits from extractive resources is typically limited to the industry’s provision of employment and a few philanthropic projects. However, extractive industries tend to have a minimal impact on the labor market. The capital intense nature of extractive industries stems from industry demand for fewer, more highly skilled workers compared to the labor-intensive, low-skilled workforce sectors – such as agriculture or manufacturing. Low prevalence of human capital in Mozambique further limits employment opportunities for Mozambicans in the extractive sector – leading to unfulfilled expectations in communities and promotes social unrest. This section provides examples and recommendations of how the Government, extractive companies, and stakeholders can increase employment opportunities for Mozambicans in the extractives sector and economic linkages between the extractive industries and Mozambique’s local businesses, especially in regions of extractive operations.

Prosperity driven by the growing extractive industry can be translated to communities in Mozambique through cultivating local content – including local recruitment, training, and purchasing local goods and services. Though not a “silver bullet” to prosperity, local content can contribute to the fulfillment of expectations that mineral and hydrocarbon production will help improve the lives of Mozambicans. Local content is also critical to the extractive industry’s operational sustainability by generating a social license to operate within a given community. Smooth, sustainable operations also benefit the state by supporting steady revenue flows and general social stability.

Given local human capital and the capacity of Mozambique’s private sector are currently very limited, it is critical that both the government and extractive companies initiate early and consistent engagement with communities and the local private sector in regard to both the type of employment and business opportunities that will be available. Additional management of expectations through transparent communication of the expected timeline of these opportunities is also necessary. To achieve optimal local content goals, the government must also invest deliberately in the provision of poverty-reducing public goods, including quality education, literacy, and healthcare, which in turn serve to improve human capital in the long-run. These efforts require significant strategic social investment by stakeholders to build the capacity of local communities and enable individuals and businesses to compete and access income-generating opportunities in the newly established extractive industry value chain. Without investment in the development of Mozambique’s human capital and building capacity of the local business sector, Mozambique’s ability to fully access and realize the potential benefits of its vast natural resource wealth will remain retarded. Finally, this section also discusses the need to develop and implement a strategic plan that mitigates inward migration, local food price inflation, and constraints on community resources affecting areas impacted by extractive industry operations in Mozambique that could be source of social instability.

Infrastructure

Marked rates of underdevelopment in Mozambique are closely tied to the country’s shortage of infrastructure, which has largely failed to respond to social and economic development needs. Although recent public, private, and donor investment in developing Mozambique’s infrastructure has focused much more on facilitating the trade derived from megaprojects, it might also represent an unparalleled opportunity to build a system that fosters inclusive social development. The Government has the option to take advantage of the international community’s willingness to invest and orient economic resources to address infrastructure-related impediments of development.

Ensuring inclusiveness, through both connection and universal access to roads, railways, and electricity, must be at the heart of this endeavor. Railways, in particular, must guarantee access for general freight and passengers, as well as for mining companies. With respect to Mozambique’s roads, an upgrade and significant extension of the network would decrease transportation costs for all parties. This, in turn, would help mitigate the country’s high rates of poverty and inequality, permitting both the mining provinces and the rest of the country to benefit from extractive industry operations. Special attention must be paid to use of roads as connectors between impoverished yet potentially productive areas and the Beira, Nacala and future Macuse corridors. Finally, despite the current efforts of the Government to bring the grid to every district, only a small percentage of Mozambicans have reliable access to electricity. The potential for clean production must be developed to provide electricity access beyond district centers, and to help reduce Mozambique’s reliance on unsustainable energy sources.

Environment

Protecting the country's ecology is critical to Mozambique's vitality and will require investment and attention to environmental governance that keeps pace with resource extraction. First, to mitigate environmental risks inherent in resource development, research into fisheries and terrestrial ecosystems is necessary to create a baseline for conservation priorities, since much of Mozambique's ecology is not well researched. The existing Environmental Impact Assessment review period is also too short for the increasing volume of assessments and the current limited capacity of the Government and civil society. Such assessments for large extraction projects and their corresponding infrastructure development should be made available to the public with a longer, more adequate review period than the current 45 days. In line with the country's existing environmental law, specific requirements and guidance on biodiversity offsets must be drafted and enforced to ensure that all small and large-scale extractive resource projects account for environmental impacts from the beginning of the project.

Mozambique's current environmental legislation should be reinforced with more detailed guidance. Exemplary laws from other countries, such as Norway, can be utilized for legal reference until a robust new set of laws can be established. With ongoing active exploration of the natural gas, Mozambique should dictate when and where seismic surveys are conducted in order to protect the delicate biodiversity surrounding the nation's corals and fisheries. In addition, the government must create an environmental emergency plan so that, should accidents occur, the various government ministries have an aligned mitigation strategy that facilitates rapid response. Additional funding, training, and resources allocated to environmental ministries are also necessary to expand their capacity to study the nation's ecology, properly implement protective legislation, and adequately monitor mining and natural gas exploration and production. Additionally, the growing artisanal mining sector needs strategic Government support to organize associations, as well as train, guide, and monitor expansion to ensure the safety and prosperity of Mozambicans. In this way, small-scale mining could become a means to reduce poverty as opposed to creating conflict and environmental degradation. All of these governance strategies will need to be implemented quickly and should utilize revenues from the extractive industry to guarantee that Mozambique's dynamic ecology continues to be a source of pride and the pillar of a growing tourism industry.

Resettlement

Resource exploration, mineral concessions, and infrastructure development have all exponentially increased the resettlement of communities in Mozambique, especially in remote areas. Although the country has the extraordinary opportunity to strategically translate its mineral assets into long-term sustainable development, extractive operations can only be fully successful if the investments are embedded in stable and prosperous communities. One of the country's top objectives should be to leverage the recent boom in extracting natural resources to improve the living conditions of Mozambicans and to ensure a prosperous environment in which companies can diligently operate.

If Mozambique follows five basic resettlement principles, the rights of Mozambicans and compliance with the international conventions and agreements that the nation has pledged to support will be ensured. First, projects that require resettlement must conduct early, inclusive and transparent consultations to give communities the opportunity to make decisions on issues directly affecting their lives. Early consultation also helps build critical buy-in from impacted populations. Second, it is key to provide communities with the tools and information to diligently participate in negotiations that reach fair agreements. Third, compensation, that

includes improved livelihoods and standard of living is key to translating resource extraction into prosperity for individuals affected by resettlement. Fourth, resettlement processes entail negative environmental impacts that must be diligently addressed as they highly impact the health conditions and access to other resources (water, soil, etc.) of the surrounding communities. Lastly, an inclusive and legitimate post-resettlement committee must oversee agreement compliance, progress, and accountability. Such a committee also recognizes that communities are dynamic and future agreements will have an established channel for discussion. A well-structured and well-managed resettlement process, jointly agreed upon by communities and companies, can help to ensure that extractive operations and other projects that require resettlement enjoy greater community buy-in and promote sustainable development.

Mozambique must also ensure that women are not left out of opportunities to participate in and benefit from the country's development through the extractive industries. The Government bears a duty to ensure women's equal access to socio-economic opportunities, reduce disruptions to their standards of living and improve livelihoods. In the context of mining operations, Mozambique can meet these challenges by implementing its existing laws and Constitutional provisions which guarantee the equal rights of men and women, along with amending existing mining legislation to address issues on resettlement, consultation and compensation.

Such arrangements also stand to benefit from local resources (including human capital), thereby reducing the likelihood of conflict. The resettlement process in Mozambique is ongoing, and there are a number of ways that the Government can promote mutually beneficial resettlement agreements leaving all parties affected better off and fairly attended.

Legal Framework

From a legal perspective, Mozambique must aim to reform and update the legislative, institutional, and contractual frameworks associated with extractive industries in order to maximize the gains from and minimize the costs of extractive resource development. In this context, Mozambique is currently reviewing its legal and fiscal frameworks for oil and gas exploration and production, to take into account developments in the industry and new gas discoveries. Recent drafts of the petroleum legislation contain several important additions that address infrastructure, revenue sharing, oversight, and environmental protection. However, the law needs further strengthening to ensure that new and existing projects are carried out in a safe, fair, and efficient manner. Vague references to "good industry practice" should be replaced with clear and transparent obligations. Deals should be standardized and their key terms should be set in legislation to improve transparency and competitiveness. Companies must be assured fair and open access to facilities to promote competition and increase efficiency. Penalties must be clear and significant to deter bad behavior. Environmental protections should take into account that companies are often in the best position to monitor, prevent, and mitigate environmental and health risks. The Government must also preserve its ability to reform and improve its legislation over time - especially in relation to the environmental, social, and health impacts of extractives.

The fiscal regime should draw on a range of different tools to generate a fair share of revenue for Mozambique. While opinions may differ on what is "fair", Government revenue should amount to at least one third of the profits for mining and 65% of the profits for oil and gas over the lifetime of a project. As the industry becomes more established, and business conditions improve, this share should increase substantially for future projects. The regime needs to balance up-front income with long-term objectives - taking into account the legitimate interests

of investors, the capacity of public agencies to administer the regime, and the interests of future generations of Mozambicans.

There is also a critical need for existing mining legislation to be examined and amended, in order to better reflect the growth of the sector and to protect the interests of the Mozambican people, particularly with respect to environmental, health, social, fiscal and contract transparency considerations. Accordingly, provisions of the current Mining Law of 2002 should be amended in these distinct areas, giving mining activities a modern and adequate regulatory basis to ensure greater competitiveness, guaranteeing the protection of rights and defining the duties and obligations of holders of mining titles. While the Mining Law of 2002 is undergoing revisions and is expected to be passed by Parliament in the coming months, this section sets forth policy recommendations which illustrate some of the gaps and challenges present in Mozambique's mining legislation. Reforms in the mining laws offer an important opportunity for the country to further develop its economy, and importantly, to promote equity, reduce poverty, and meet its development goals through a forward-looking approach. The recommendations in this section are offered to strengthen, clarify and update existing mining legislation, and provide guidance on how mining activities can be conducted in a manner, which prioritizes and improves the social and economic well being of the Mozambican people.

Governance

The Government must adopt a transparent and uniform policy framework and fiscal regime to effectively administer the process of extractive industry development vis-à-vis government costs and revenues. To this end, Mozambique should create an accountable and transparent framework of governance to manage its extractive assets. There must be checks and balances built into the institutional structures of the Government. This will create accountability, separate responsibilities to minimize conflicts of interest, expand powers for specific agencies to fulfill their roles, and allow for agencies to manage extractive resource development accordingly. Mozambique must also focus on anti-corruption measures to improve its governance. Some useful tools include the anti-corruption law as well as other Information and Communication Technology platforms that can help bolster the country's systems of oversight. Above all, transparency must become a fundamental part of the extractive industry's contractual process, to ensure that all parties are getting their fair share of revenue.

Sovereign Wealth Fund

Sound revenue management is key to the sustainable development of Mozambique's economy. The financial impact of natural gas and coal exportation can have detrimental effects for the country. As mentioned above, problems arise from real exchange rate appreciation, which puts other export industries out of business, and from fluctuation in commodity prices, which is destabilizing for the domestic economy. Establishing a sovereign wealth trust fund in a traditional financial center will help Mozambique absorb the coming windfall and promote growth and development in the country in five key ways. First, it effectively shelters the domestic economy from the commodity sector, so that volatility in oil, gas or coal prices do not have such a disruptive effect on the country's budget planning from one year to the next. Second, by channeling revenues into specific development programs, the fund can help the government to focus and plan for expansion of infrastructure, education, healthcare and public services. Third, the fund can help to ensure that government revenue from extractive resources become an ongoing source of income for decades to come, and provide intergenerational equity. Fourth, and crucially, a sovereign wealth fund can insulate Mozambique's currency, helping to ensure that investment in the extractives industry does not have negative impacts on other

sectors of the economy. Finally, the trust will legally enshrine the purpose of the fund and thus insulate Mozambique's fund from sovereign debt and facilitate the country's access to international financial markets due to improved legal standards.

Mozambique Moving Forward

Mozambique is embarking on potentially one of the most defining opportunities of the nation's history. Despite the impoverished state of much of the country, Mozambique is endowed with significant hydrocarbon and mineral resource wealth in an era that is experiencing innovation, awareness, and collaboration at an unprecedented rate. The nascent development of Mozambique's large-scale hydrocarbon and mineral reserves is a point of strength and opportunity for structured and deliberate leadership to shape the future of Mozambique into a prosperous regional authority with the capacity to be a source of strength and guidance beyond its borders.

There is universal familiarity with the potential outcomes that lie ahead for Mozambique. The nation's limited human capital and restricted absorption capacity of the local public and private sectors to adapt and manage the rapid changes underway exemplifies the necessity for Mozambique to engage actively, early, and transparently to realize the opportunities at hand. However the continuum that flows between a resource blessing of prosperity and a resource curse is process of significant complexity. Multi-directional relationships between the economics, social, environmental, political and legal aspects of natural resource development requires clear frameworks and implementation of transparent objective that will benefit the nation now and for future generations. The areas this report examines identifies the current and potential weakness that could derail Mozambique's intention to pursue a path of sustainable development that is supported by revenues and income generating potential of the growing explorations and production of Mozambique's natural resources. Each section also includes recommendations that address the challenges and opportunities specific to the changing environment of Mozambique's natural resource extraction.



Photo: Gorongosa National Park
Mozambique
Piotr Nasrecki

Introduction

On the south-eastern coast of Africa, Mozambique is a country of extraordinary natural beauty and cultural diversity. While its natural riches have been known to the world for centuries, it is only recently that the discovery of extensive gas reserves and coal deposits have drawn the attention of foreign investors.

As one of the least developed countries in the world, Mozambique faces significant challenges to bring these resources safely and sustainably to market, and to manage the resulting funds. In the aftermath of independence and a devastating civil war, the country has made significant progress to build social stability and begin to lift its people out of poverty. However, much work remains – and while extractive resources offer opportunities for prosperity and growth, the influence of multinational corporations, donors and international organizations (each with different interests) has complicated an already complex environment.

This project has reviewed Mozambique's unique economic, legal, institutional, environmental, and social context to assess the potential impact of the extractive industry (both positive and negative). Through consultation, research and interviews, the team has drawn on the knowledge within Mozambique, as well as on the experiences of other countries, to formulate a number of specific and implementable recommendations that will help Mozambique to mitigate the risks and maximize the benefits of extractive industry development. Our team's particular focus has been to harness the existing strengths and potential within Mozambique civil society and government, and to prioritize key areas of reform.

The Capstone team began work in November 2012, and carried out desk research from Columbia University in New York for several months. In March 2013, eleven team members

traveled to Mozambique. While most of our time was spent in Maputo conducting interviews with stakeholders, companies, donors, NGOs and Government agencies, two team members traveled to Pemba to research the new natural gas developments in that region. We were privileged to have the assistance and insight of dozens of committed people during this period. Although our visit was brief, we were able to conduct over 40 meetings addressing the broad scope of issues covered in this report. On our return to New York, further research supplemented our interview material.

The resulting report is divided into nine sections, each with a particular focus. However, many of the issues overlap – and these themes are addressed from several angles. Key themes that emerge throughout the report are the importance of education, the need for engagement and consultation with local communities, and the opportunity for Mozambique to learn from and improve upon international experience.

Section 1 provides an overview of Mozambique’s Economic and Commercial context, and introduces some of the key considerations for the development of extractive industries. In addition to outlining the prospects for Mozambican gas on the world market, this section discusses the important issues of contracting and financing LNG production. The local and global commercial prospects of coal production are also discussed.

Next, we address the importance of creating linkages between foreign enterprises that invest in Mozambique’s extractive industry, and local companies. In particular, the section highlights that small and medium-sized enterprises need support, regulation, infrastructure, and training to improve their efficiency, and to engage in commercial relationships with international investors. By encouraging “linkages”, Mozambique can ensure that foreign companies are more integrated and more efficient, and that the benefits of extractive industry can flow directly to the communities where they operate.

Section 2 expands on this idea, exploring the benefits and practicalities of “local content” requirements. Employment of local residents, procurement from local suppliers, and other forms of local input can increase efficiency for companies and generate “social license to operate.” This section provides an overview of Mozambique’s socio-economic context and a close-up view of two regions that are greatly impacted by coal and natural gas development – Tete and Cabo Delgado, respectively. Finally, the section addresses areas of risk and strategies for mitigation, including inward migration and inflation.

Section 3 provides a snapshot of Mozambique’s infrastructure with a focus on roads, railways, and energy. It assesses the potential impact of expansion by extractives companies and presents an argument for inclusive infrastructure – infrastructure that is accessible and affordable for local people, and for other enterprises.

Section 4 highlights the multiple, complex environmental concerns that extractives development raises. Natural gas exploration and production and coal mining both present threats to the environment, to livelihoods, and to health, including marine life, water quality, air quality, land, and biodiversity. The section presents a number of recommendations for legal and institutional changes that will help to preserve Mozambique’s unique ecology and landscape, and to protect the health of its people.

Section 5 presents an analysis of the impacts of resettling communities to make way for

extractive resource projects. The section highlights the importance of an early, open, and inclusive consultation process, founded on free and informed consent. Recommendations focus on improving resettlement practices, including compensation and protecting livelihoods, and identify the particular safeguards that are needed uphold the rights of women.

Section 6 moves to the legal framework for mining in Mozambique. It outlines the current legislative provisions and licensing process, and provides detailed recommendations on how these laws can be strengthened and improved. Environment, resettlement, fiscal and transparency issues are all considered.

Section 7 assesses the existing gas and petroleum laws, and discusses options for reform in light of the most recent draft amendments. It presents an analysis of the “gaps” in the law and touches on the particular issue of foreign investment and arbitration.

Section 8 presents the case for strong and reliable institutions to govern extractives industry in Mozambique. It outlines the progress that Mozambique has already made towards transparency, and recommends general and entity-specific policy changes. Capacity building and e-governance are also discussed.

Section 9 proposes a sovereign wealth fund for Mozambique, with a structure that will help to ensure that extractive industry revenues are a blessing, and not a curse, for the country. The section outlines how a sovereign wealth fund can help to manage Dutch disease and inflation, presents options for managing and investing the resources, and identifies the various funds which could be created to direct revenues into the Government budget, stabilization, development and savings, development.

The report concludes with a summary of the Recommendations, and a Bibliography of sources.

The Appendices are intended to provide additional detail and context for interested readers. They include resources that have been collated by the authors from a range of different sources, for ease of reference. Appendix 1 sets out a number of tables with additional detail about the legal framework and contracts for mining, gas and petroleum, including some advantages and disadvantages of the different types of fiscal tools used by governments to collect revenue from extractive operations. Appendix 2 includes resources for Sovereign Wealth Fund governance, including international comparisons, details of the *Santiago Principles* and the Linaburg-Maduell Transparency Index. Finally, Appendix 3 includes relevant development indicators for Mozambique, along with comparison countries for reference. The tables incorporate economic, commercial, social and governance indicators, and serve as a “snapshot” of Mozambique’s current development.

A Note on Priorities

This report sets out 105 distinct recommendations for Mozambique, covering economic, infrastructure, social, legal, environmental, governance, and financial issues. The recommendations, which are summarized at the conclusion of the report, should provide guidance and provoke discussion among government, civil society, donors, and the business community. However, it is unrealistic to expect that Mozambique will be able to address all these issues immediately and simultaneously. The people of Mozambique must decide what issues are most pressing and most important for themselves.

This section is intended to give an outline of what the Capstone project team identified as the key priorities for change in the short and medium term.

Get the legal framework right to ensure a balance of rights and responsibilities

Mozambique's legal framework for oil, gas and mining needs drastic changes to address the challenges that lie ahead. It is essential that the new laws set out clear and detailed obligations for companies and for the government about responsible environmental and social practices. Where gaps remain, the laws should refer to the rules of jurisdictions with robust laws, such as Norway and Australia. The fiscal regime must also be clear, transparent, and standardized for all projects – not negotiated on a case-by-case basis. Closely related to the law is the importance of institution-building to enable implementation. Mozambique's ministries and government agencies must have the support, the training, the power, and the resources to effectively negotiate concession contracts, regulate, monitor, and enforce the legal framework.

See: Section 6: The Need for Upgraded Mining Laws, Section 7: Gas and Petroleum Laws, Section 8: The Case for Strong and Reliable Institutions, and Section 4: Protecting Mozambique's Environment.

Carefully manage the revenues from extractive industries for the benefit of all Mozambicans

Oil, gas and mining have immense economic potential – but that potential will only be realized if projects are taxed appropriately, and revenues are managed carefully. Once a fiscal regime is in place, the revenues from all projects should be paid into a resource fund that is designed to suit Mozambique's situation. A Sovereign Wealth Trust Fund would provide a structure that is clear and straightforward, with enough flexibility to allow for different stages of development. First, extractives revenues could contribute to initial budget funding (in lieu of donor funding), and could be used to help stabilize the economy. As the fund grows, investments in infrastructure and special development projects could follow. Ultimately, the fund could also incorporate a savings fund that generates wealth for decades to come.

See: Section 1: The Economic and Commercial Implications of Natural Gas and Coal, and Section 9: Managing Wealth: The Sovereign Wealth Fund.

Provide economic opportunities by making infrastructure inclusive and accessible

Infrastructure development will be an essential component for Mozambique to turn its resources into commodities. However, infrastructure that serves only large commercial enterprises can exacerbate inequality. The government must plan carefully to ensure that the money invested in infrastructure has as many flow-on benefits as possible – this means

engaging with small enterprises and with the public to ensure access to reliable transport and electricity networks.

See: *Section 3: The Need for Inclusive Infrastructure.*

Protect and empower local populations to preserve stability

Mozambique must immediately address the disruptive impact of current and future resettlement projects to ensure that local populations do not lose out when extractive projects take place in their region. Over time, these disruptions can violate fundamental human rights, entrench poverty, cause social unrest, and make it impossible for businesses to operate efficiently and safely. By encouraging local content and local linkages, Mozambique can help to ensure that foreign investment is more efficient and contributes to real, sustainable benefits to the community.

See: *Section 2: Translating Extractive Industry Prosperity to Mozambique’s Communities and Section 5: Ensuring Social Equity in Extractive Industries-Based Development.*

Education is critical to sustainable growth and a better quality of life

Although it is not a dedicated topic in this report, education and capacity-building is a common theme in our analysis. Training and education will help Mozambique’s lawmakers, officials, civil society, business people, and all citizens to make good decisions about managing extractive resources. The revenues from those resources, in turn, should be invested in improving the quality and accessibility all levels of education – from primary through to specialist tertiary education.

See: *Section 2: Translating Extractive Industry Prosperity to Mozambique’s Communities, Section 4: Protecting Mozambique’s Environment, and Section 8: The Case for Strong and Reliable Institutions.*

Foster and protect Mozambique’s other “comparative advantages”

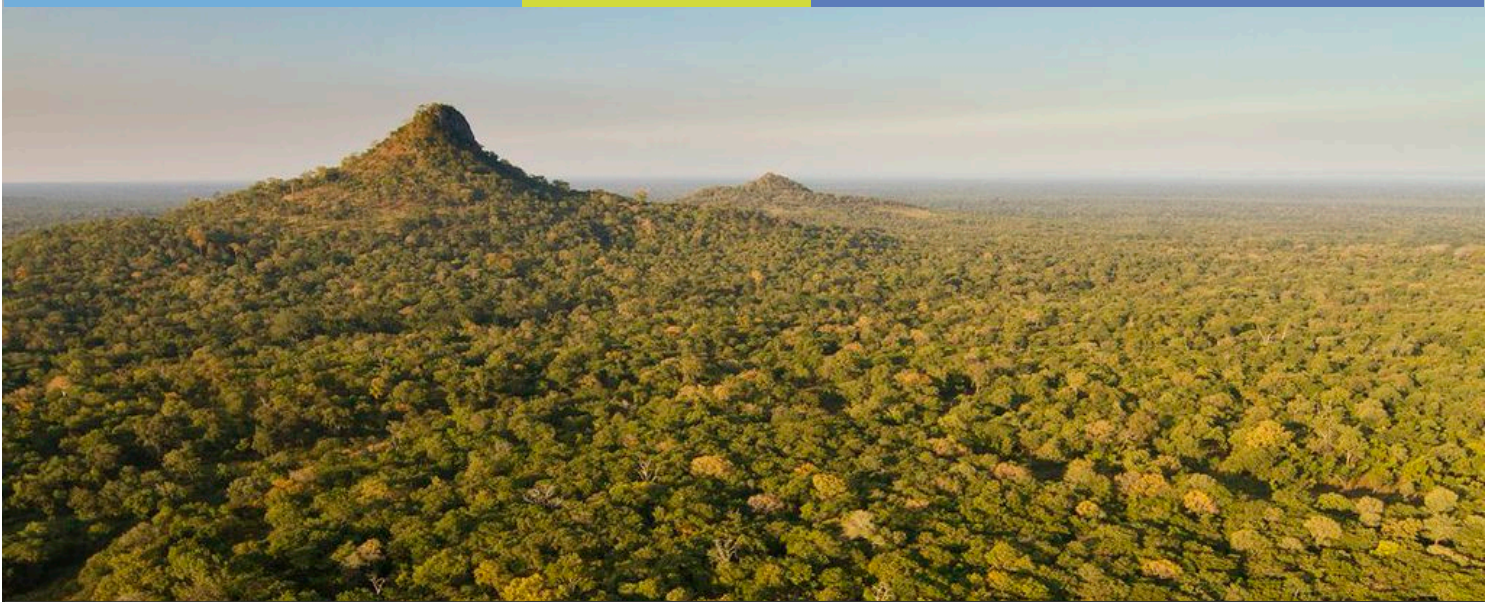
Once the coal has been mined, and the gas extracted, Mozambique will need to depend on its people, its land, and its waters for continued economic growth. Among others, Mozambique has the potential to develop a vibrant agricultural sector, and a world-class tourism industry. But both of these sectors could be seriously threatened if extractive developments are not well planned or well regulated. Loss of arable land to mining, pollution or contamination of water, disruption of habitats, and the physical scars of extractive industries will directly impact this economic potential. It is possible for these industries to coexist – but only if strong and enforced laws protect the environment and the people of Mozambique.

See: *Section 4: Protecting Mozambique’s Environment, and Section 5: Ensuring Social Equity in Extractive Industries-Based Development.*



Mozambique

mobilizing extractive
resources for development



Section 7

Gas and Petroleum Laws

Photo: Gorongosa National Park
Mozambique
Piotr Nasrecki

7 Gas and Petroleum Laws

Mozambique's legal framework will be an important tool in the effort to ensure that recent discoveries of gas can be transformed into a sustainable and positive driver for development. It is crucial that government, industry, donors and civil society work together to formulate the best possible regulations and institutional frameworks *before* production of these new reserves begins on a large scale. Getting the legal framework right will help set Mozambique on the path to economic growth and prosperity, without sacrificing the country's unique cultural and environmental treasures, or threatening its hard-won social stability.⁴⁰⁸

This section outlines the current and proposed legal framework for Gas and Petroleum extraction in Mozambique, and provides a number of recommendations to strengthen the relevant legal rules and processes. In addition, detailed commentary and analysis is set out in Appendix 1: Law.

7.1 Overview of the current Framework

7.1.1 Laws and Regulations

Mozambique's first law to regulate the oil industry was enacted in 1981, and was extensively revised in the early 2000s. The current law in effect is the *Petroleum Law 3/2001*, which provides a basic scheme of licensing and regulation for petroleum exploration. The act was reviewed in 2007 to establish new administrative and fiscal conditions for oil and gas production. More detailed obligations are set out in the Petroleum Regulations, and in other laws relating to the fiscal regime, environment, health and safety.⁴⁰⁹ An overview of the current law follows.

Ownership and basis for activities

The Constitution and the Petroleum Law both provide that all natural resources in the soil and sub-soil, interior waters, territorial sea⁴¹⁰, on the continental shelf and in the exclusive economic zone are the property of the State of Mozambique. In order for a person to conduct activities in relation to petroleum or gas, the state must grant that person a contract (a "concession contract").⁴¹¹ While both foreign and domestic entities can apply for a concession contract, "under equal circumstances" preference is given to Mozambican⁴¹² businesses or their affiliates.⁴¹³ Importantly, the State reserves the right to participate in any operations conducted by the holder of petroleum or gas operation rights (the "concessionaire") under a concession contract. Currently, it does this through the national oil and gas company, National Enterprise of Hydrocarbons ("ENH").⁴¹⁴ For a more detailed outline of these contracts and their key terms, see *Appendix Appendix 1C: Existing Gas and Petroleum Contracts under the Petroleum Law 2001*.

Fiscal regime

The current fiscal regime is set out in the Petroleum Law, the Petroleum Tax Law, the Fiscal Incentives Law, and specific terms for each concessionaire are set out in the relevant concession contract. Generally, royalties between 2-15% must be paid on petroleum,⁴¹⁵ with an additional petroleum production tax of 10% for crude oil and 6% for natural gas.⁴¹⁶ Fiscal benefits are available only after a discovery, for a period of five years from the date of approval of a development plan.⁴¹⁷ These benefits

include exemption from customs duties, VAT and the Specific Consumption Tax for certain equipment used in petroleum operations.⁴¹⁸ Deductions from income tax are specified in the concession contract.⁴¹⁹ In addition, any profit or gain arising on transfer of an interest under the contract is treated as a capital gain that is subject to corporate income tax. A more detailed discussion of the current fiscal regime, is discussed in *Section 1.2.2: Financing Liquefied Natural Gas Development*.

Local content, community and government support

The Petroleum Law includes only a general local content obligation whereby concessionaries are required to give preference to Mozambican products and services, provided that those goods and services are “competitive in terms of price and comparable in terms of quality and supply”.⁴²⁰ This is a comparably soft obligation, as there are no standards or mechanisms to guide the concessionaire in making that assessment of “competitiveness”.⁴²¹ The Model EPCC contains a more detailed (but still soft) obligation in relation to the preferential employment and training of Mozambicans.⁴²²

The Model EPCC sets out provisions for the concessionaire to provide unspecified amounts of financial contributions specifically for:

- institutional support to Mozambique government entities involved in promoting and administering Petroleum activities, to be paid within 30 days of the Effective Date of the Contract;
- training support programs within the government, to be paid annually for the period of exploration; and
- social support programs in the local communities where operations are carried out, to be paid annually for period of exploration.⁴²³

Environment, Health and Safety Obligations

The Petroleum Law contains a general provision stating that the granting of rights for petroleum exploration, development and production activities “shall always respect national interests in respect of defence, navigation, research and conservation of marine resources and the environment in general”.⁴²⁴ Article 23 of that law states that all holders of exploration and production rights must carry out their operations in accordance with:

- “Good Oilfield Practice”, discussed further below at *Section 7.3.1: Clarifying, Modernizing, and Strengthening the Gas and Petroleum Legislation*
- environmental and other local legislation;⁴²⁵ and
- the terms of the individual Concession Contract.

The article goes on to identify a number of specific objectives that the concessionaire must satisfy, such as to prevent and mitigate ecological damage, to control and prevent oil spills, protect health and safety, and to restore the environment once operations are decommissioned.⁴²⁶ The concessionaire is also required to prepare an environmental impact assessment (“EIA”) in accordance with “internationally acceptable standards”.⁴²⁷ EIAs are discussed in more detail in *Section 4: Protecting Mozambique’s Environment*.

7.1.2 The Model Contract

Because of the rapid growth of Mozambique's petroleum and gas industry, many issues that were not fully addressed in existing legislation have instead been included within the Model EPCC. The fiscal regime is perhaps the most important example of this. In other cases, the rules set out in the Model EPCC may restrict the powers and processes set out in legislation. Two examples, relating to regulatory stabilization and dispute resolution are mentioned here, and are discussed in further detail elsewhere in this report.

Stabilizing the economic benefits of the Contract

"Stabilization clauses" are a particular type of guarantee often sought by companies to manage "regulatory risk". Regulatory risk is the risk that a change in laws or regulations (made by the government) will materially impact the business. For example, if a state decides to impose a carbon tax on polluting activities, this makes those activities less profitable. Stabilization clauses provide investors with a measure of security at the outset of a project. The Model EPCC includes a stabilization clause to ensure that the economic benefits represented by the Contract at the time it was agreed cannot be eroded or reduced by operation of other laws or regulations. It states that:

- if any tax is introduced that affects the economic value derived by the concessionaire from petroleum operations; or
- if there is any change in legislation concerning petroleum operations that has a serious adverse effect on the economic benefits of either the concessionaire or the government,
 - the parties agree to meet as soon as possible to try to agree changes to the EPCC to restore, as closely as possible, the economic benefits that would have been enjoyed had the legislation not been implemented. This means, essentially, that if the government introduces new laws (such as more strict environmental regulations) it may have to cover the concessionaire's cost of complying with those laws. While we are in favor of limited *fiscal* stabilization guarantees in contracts, we do not think that a general stabilization commitment should be made in any circumstances. For more detail, see the discussion in *Section 7.3.1: Clarifying, Modernizing, and Strengthening the Gas and Petroleum Legislation*.

Arbitration as the default for dispute resolution

The Petroleum Law states that disputes between the parties relating to contracts should be addressed first by negotiation, and if that fails, then in judicial proceedings or arbitration. Four alternative mechanisms for arbitration are listed, including arbitration under the rules of the International Centre for Settlement of Investment Disputes ("ICSID"). The Model EPCC, by contrast, specifies that there are only two mechanisms for dispute resolution – expert determination (for technical matters) or ICSID arbitration (for all other matters). This means that neither party can bring a dispute relating to the Concession Contract to the Mozambican court.⁴²⁸

Arbitration provisions are common in many investment agreements, and arbitration itself can be a useful tool for states without a strong judicial system, or where projects are very politically sensitive. But there are also downsides. Arbitral decisions in relation to the extractives industry have caused significant concern in some jurisdictions. For example, a dispute between Chevron and Ecuador over pollution in the Lago Agrio oilfield has become an ongoing battle, played out in arbitral panels and in

domestic jurisdictions. The dispute has “stretched the boundaries of arbitral authority” and cost both parties a fortune in legal fees.⁴²⁹

It is important for Mozambique to weigh the benefits and disadvantages of arbitration over other forms of dispute resolution, such as mediation or litigation in the domestic courts. Because arbitration takes place outside of the state, it may be more removed from the “public interest” considerations that a domestic judge would often take into account when adjudicating a dispute between the government and a private company. There is a perception that ICSID Arbitration, especially, tends to favor private investors over state interests.⁴³⁰

The costs of arbitration can be significant for any country – but for a country such as Mozambique, the threat of arbitration may be so strong that the government will choose not to make the regulations at all. This is referred to as a “chilling” effect on the government’s ability to regulate.⁴³¹ For more detail see *Section 7.3.3: International Investment Protection and Arbitration*.

If the government seeks to resolve issues such as the ones mentioned above, it can be helpful to include the clarifying provisions within the legislation itself, rather than agreeing to different terms for each company that obtains a contract. The following section explains why we favor including details in legislation and not in contracts.

7.2 What works best, legislation or contract?

One common issue for countries that are in the early stages of developing their extractive resources is whether to focus the details of each deal in the contract itself, or whether to provide a more rigid framework in legislation. There are several considerations to keep in mind:

- **Flexibility:** A contract-by-contract approach allows the government to adapt its requirements and its rights to suit the particular features of each project, and to suit the characteristics of each counterparty.
- **Uncertainty:** However, as a result of this flexibility, there can also be considerable uncertainty for investors when they start the negotiation process.
- **Complexity:** When important provisions are contained in the contract, and not in the legislation, any variations in the deal cause complexity for regulators as they monitor the implementation of each project.
- **Costs:** While legislation can be time-consuming to draft and to change, a more complete legal framework can significantly reduce the time and cost involved in negotiating each contract.
- **Transparency:** So long as negotiations and contracts remain confidential between the Government and the concessionaire, legislation is a far more transparent and democratic way to regulate extractives projects.

Overall, we think that the benefits of certainty, transparency, and consistency provided by the legislative framework outweigh its disadvantages.

Recommendation 57: The Government of Mozambique should standardize and set out in legislation as many details of the deal as possible. This will provide greater transparency for investors, and a more accountable democratic process.

7.2.1 Balancing Confidentiality and Freedom of Information

Why is it so important to align legislation and contractual provisions? One illustration of the problems that can arise is related to the publication of concession contracts, of information obtained about the gas and petroleum operations themselves, and the confidentiality provisions of the contracts themselves. Article 19 of the Petroleum Law states that all data obtained pursuant to any contract is the property of the Mozambican state. However, at present, the Petroleum Regulations guarantee that, “[u]nless otherwise agreed, all data gathered under ... Concession Contracts shall be kept confidential”.⁴³² The Government does reserve to itself the right to make general statements on the Petroleum Operations conducted under a Concession Contract, and the probabilities of discovering petroleum,⁴³³ but there are no other exceptions to this general rule set out in the regulations.⁴³⁴

Freedom of information – balancing public and private interests

While it is important that investors are able to keep commercially sensitive information out of the public domain, there are also legitimate and competing interests for the public to know about the activities carried out under concession contracts. This could become an important issue if Mozambique decides to publish its concession contracts, or to pass legislation on “freedom of information”.⁴³⁵ Freedom of information laws have become increasingly common in the last decade, with India, Bangladesh, Chile and Indonesia all enacting new legislation. Mexico was the first Latin American state to pass a freedom of information law in 2002, and it has since become a model worldwide.⁴³⁶ The law, and the institution it established (IFAI – Instituto Federal de Acceso a la Información), has helped the government to become more efficient. It has also helped citizens, media and businesses to engage more effectively on a range of issues such as environmental protection, public services, and revenue management. A constitutional reform was passed in 2007 to ensure the right to information for generations to come.⁴³⁷

Often, freedom of information laws will require the government to weigh the public interest and the commercial interest when deciding whether to disclose information. On the one hand, the government may refuse to disclose information if its disclosure would unreasonably prejudice the commercial position of the person who provided the information.⁴³⁸ Such protections encourage companies to continue to deal with the government, and to be open and honest about their activities. On the other hand, the government should choose to disclose the information if other considerations make it more desirable, in the public interest, to make that information available (such as health, safety or environmental considerations). This balancing exercise is an important, and difficult one.

Leaving the detail to the contract creates uncertainty

If Mozambique were to enact a freedom of information law, it could conflict with the existing Petroleum Regulations, and potentially with the terms of the Concession Contracts already agreed by the Government. This is because the regulation leaves it up to the Contract to set out when reports or plans submitted by a concessionaire can be disclosed. The 2010 Model EPCC confirms the guarantee of confidentiality set out under the Regulations. It also goes further, and provides that the Contract itself is confidential. The Model EPCC does provide an exception to its confidentiality provisions if the disclosure

is reasonable and “is required by any applicable law.”⁴³⁹ This would appear to allow the Government to disclose information in accordance with a freedom of information law. However, the Model EPCC goes on to state that this exception will only apply if the Government can ensure that the person who receives the information will treat it as confidential. This means that media or investigators who sought information would not be able to publish it or pass it on. Finally, even if the government tried to pass legislation to resolve the conflict, it could be liable under the Concession Contract (see, e.g. the discussion of “Stabilization Clauses” above).

In the latest version of the draft Petroleum Law, the government has clarified its right to inventory revenues from a gas or oil operation, and to publish those revenues periodically. This is a step in the right direction, but it should be expanded to cover other important issues.

Recommendation 58: The Petroleum legislation itself must contain an exception from confidentiality provisions of future Concession Contracts for appropriate situations where there is a strong public interest in disclosure, particularly in respect of health, environment and social impacts. The government should also seek to agree with existing concessionaires appropriate guidelines for disclosure of information to the public.

7.3 Important Developments in the Legal Framework

The Mozambique Government is currently undertaking two very important reforms in relation to Petroleum and Gas:

- First, it is **reviewing the Petroleum Law 2001** to modernize its provisions, and to incorporate gas exploration, production and facilities within its scope. At the time of writing, the revised draft law had been approved by cabinet, and is awaiting debate by Parliament.⁴⁴⁰
- Second, the government is also **reviewing the fiscal framework** for Petroleum and Gas, as set out in the 2007 Law.⁴⁴¹

The following section sets out a number of our recommendations in relation to these two very important reform projects.

7.3.1 Clarifying, Modernizing, and Strengthening the Gas and Petroleum Legislation

Mozambique is currently reviewing its Petroleum Legislation to take into account developments in the industry, the large discoveries of gas, and institutional changes to manage its resources. Since the Government now considers natural gas, instead of oil, as the primary source of its future income in this sector, this reform is essential to ensure that the development of gas-related infrastructure, particularly Liquefied Natural Gas (“LNG”), has a robust legal framework.⁴⁴² The government, private sector, and civil society have made considerable efforts to modernize and improve the legislation, and those efforts should be commended. The latest version of the revised legislation contains several helpful amendments intended to make the law “more clear and predictable for investors and make the country more attractive for investment in the petroleum industry.”⁴⁴³ For example:

- **“Facility” contracts for infrastructure:** As part of incorporating gas into the regulatory

framework, the draft law introduces the concept of a “facility” or infrastructure Concession Contract (in addition to the existing pipeline contract).⁴⁴⁴ The concessionaire must also establish a fund that will finance the closure and decommissioning of infrastructure, so that the land can be restored.⁴⁴⁵ This is an important development in the legislative framework, since the construction and operation of gas infrastructure is a crucial component in the development of Mozambique’s gas resources, and should be subject to the same rigorous and competitive bidding process as the exploration and production concession contracts.

- **Obligation to report discoveries:** The draft law clarifies the requirement that the concessionaire must report to the Government any discovery in the area of the Concession Contract, by stating a time limit, namely within twenty-four hours.⁴⁴⁶

The draft law also includes a number of important changes to empower the government to regulate effectively, and to manage the potential downsides of oil and gas extraction and development:

- **Transparent ownership:** The new law stipulates that the foreign legal entities that directly or indirectly own or control entities that hold rights under a Concession Contract must be established, registered and administered from a transparent jurisdiction.⁴⁴⁷ That means that the [government of Mozambique/that state] must be able to independently verify the ownership, management and control and tax status of the foreign person. In addition, applicants that are legal entities must submit proof of incorporation along with their application, including documents that certify the identity of shareholders, and the amount of shares held by each.⁴⁴⁸
- **Revenue-sharing with communities:** The new law will also provide that part of the revenue from petroleum operations will be allocated in favor of communities that live in the areas around oil and gas developments, although the percentage of total revenue to be allocated has not yet been set.⁴⁴⁹
- **Greater powers of oversight, inspection and publication:** New provisions allow the government to inspect facilities or locations where petroleum operations are being carried out, and to inventory the revenues from petroleum operations and publicize them periodically. This will give the government firm legal authority to disclose information on revenues in accordance with its EITI obligations (see discussion in *Section 8: The Case for Strong and Reliable Institutions*).
- **Third party access to facilities:** The draft law allows the government to determine the rules and approve contracts relating to third party access to infrastructure.⁴⁵⁰ The government can also fix a methodology to calculate tariffs for such access, and approve the transfer of ownership or right to use infrastructure.⁴⁵¹
- **Environmental protection:** The draft law also includes measures that provide greater protection to the environment and to local communities, comprising an assurance that companies pay compensation to any persons who are injured due to loss or damage arising from the petroleum operations, in accordance with law.⁴⁵² It sets out that if the concessionaire damages crops, soils, buildings, wireless network equipment, or other improvements on the land in the course of carrying out the petroleum operations, the concessionaire must indemnify the holders of such property in accordance with applicable law.⁴⁵³ Most significantly, it also provides for strict liability of the concessionaire if the oil operations cause environmental damage or pollution.⁴⁵⁴

However, there are also some gaps remaining that must be addressed before the legislation is approved

by Parliament and, importantly, before the next round of concessions is completed. The most important recommendations are set out below.

Strengthen “good practice” by referring to model laws

The current law requires that contract holders comply with “good practices” of the petroleum industry. This term is defined by reference to “practices and procedures that are commonly used in the international petroleum industry”. While the revised draft law has improved this definition by upgrading it to “best practices” and introducing a reference to health, further clarity must be provided. As discussed above in relation to mining, the law could set out more specific standards itself, and could incorporate more complete rules by reference to another jurisdiction or to international standards (see *Section 6.2.1: Policy Recommendations to Clarify, Strengthen and Modernize the Existing Mining Legislation*).

An argument is sometimes made that, since oil and gas are capital-intensive industries, and Mozambique is a less-developed country, it *can’t afford* to impose the highest standards. It should seek to maximize its profits and to tolerate “reasonable standards” by oil and gas companies. That is, a “reasonable standard” of environmental protection, safety, and risk-management, taking into account the costs. The argument continues that, over time, companies will be able to “upgrade” their practices and standards once the investments are profitable or once the technology is available at lower cost.

This is a flawed, and dangerous argument. Mozambique can, should, and must demand the highest standards of safety, environmental protection, and risk mitigation from every oil and gas company operating on its land or in its waters. It can’t afford *not* to. Cleaner technology, safer practices, and good management can be effective in Mozambique just as it has been effective in Norway, Australia, and Canada. For the companies, it is far more efficient to invest in good technology upfront than it is to upgrade later on in the lifecycle of a project. For the government, it is easier to agree on high standards at the outset than it is to ratchet up regulations later on. For communities, environmental damage can be irreversible, and its health impacts can be devastating. The legal framework is an essential part of ensuring that the oil and gas companies operating in Mozambique create wealth an opportunity instead of destruction.

First, the definition should be amended to refer to the “best practices” of the petroleum industry by reference to “practices and procedures that meet the highest standards of the international petroleum industry”. Second, regulations should ideally set out the precise rules, guidelines and minimum standards to be met by concessionaires. However, since Mozambique is still developing its extractives industry and its expertise, a good option is to include references to international standards (where they exist) or to a foreign jurisdiction’s rules or standards as a “backstop” or default in the absence of relevant Mozambican rules.

By way of example, the Draft Petroleum Law places new restrictions on gas flaring, permitting it only in circumstances where alternative measures for disposing or storing gas are unsafe or environmentally unsound. This marks a departure from the current regime under which commercial factors are decisive in deciding whether to allow flaring.⁴⁵⁵ Still, whenever the legislation asks the company to weigh two disposal processes, there will be a strong drive for the company to justify utilizing the cheaper option. The legislation could be strengthened by developing regulations in accordance with the guidelines set out by the World Bank as part of the Global Gas Flaring Reduction (“GGFR”) partnership.⁴⁵⁶ As an interim measure, the legislation could refer to the laws of the Canadian province of Alberta, which has been recognized by the World Bank as having one of the most comprehensive and transparent gas flaring and

venting regulatory regimes in the world.⁴⁵⁷

Incorporation by reference is a drafting technique that gives legal effect to legislative text (which I refer to as the “model law”) without reproducing the model law in its entirety.⁴⁵⁸ References can be more specific (e.g. referring to a particular legal provision or regulation) or more general (e.g. referring to the laws in force in relation to a particular subject or situation). They can be static (i.e. referring to the model law as it was at a particular time) or ambulatory (i.e. referring to the model law as it is amended and updated from time to time). In addition, the reference can be entire (i.e. where the model law is incorporated as a whole), or conditional (i.e. where the model law applies subject to certain amendments or exclusions). Each of these options has benefits and disadvantages.⁴⁵⁹ An example in the context of flaring might be:

Except to the extent expressly provided by regulation under Article 28, the flaring of natural gas shall only be permitted in Mozambique if such flaring would be permitted in accordance with the laws applicable to flaring in force in Alberta, Canada, from time to time.

Researching, drafting and promulgating regulations are time-consuming and expensive. By referring to standards developed internationally, or in foreign jurisdictions, regulators can establish a legislative framework quickly, learn from its successes and mistakes, and save resources. Reference laws can be useful for both regulators and companies because the model jurisdiction can provide examples of how those laws have been applied, complied with, and enforced.

However, reference to a model law or standard is not a “quick fix”. It is important that the Mozambique regulators are comfortable with the provisions and implementation of the model law, and have the capacity to enforce it, see Recommendation [x] below.

Recommendation 59: To define “good practice” or “best practice” the amended Petroleum Law should refer to the highest international standards of the oil and gas industry, and should include specific rules and standards, either in regulations, or by incorporating references to “model laws”. These model laws can be drawn from the best available international standards or from the laws of foreign jurisdictions.

Stabilization clauses should be limited

As discussed above, the current stabilization clause set out in the Model EPCC is very broad – it is an “economic equilibrium clause” that essentially guarantees a “freeze” in the economic effects of all regulation. This means that if Mozambique chooses to upgrade its environmental or health regulations, for example, the Government must agree to “restore, as closely as possible, the economic benefits that the concessionaire would have derived if the change in the legislation had not been effected”.⁴⁶⁰ Essentially, if the law changes, the Government pays.

In addition, the clause goes on to provide a more complete “stabilization” guarantee. The second paragraph states that the clause should “not be read or construed as imposing any limitation or constraint on the scope, or due and proper enforcement, of Mozambican legislation”, so long as the legislation: (i) does not discriminate or have the effect of discriminating against the concessionaire; (ii) provides for the protection of health, safety, labor, the environment or for the regulation of property or any activity carried on in Mozambique; and (iii) that any measures taken for the protection of health, safety, labor or the environment “are in accordance with standards that are **reasonable and generally accepted** in the international petroleum industry”. This final condition (along with Article 28.1) suggests

that the Government would not be permitted to change the Petroleum legislation or other legislation affecting petroleum operations if that change would impose standards that are not “reasonable” or are not “generally accepted”, that is, if they are higher than the general standards of the international petroleum industry.⁴⁶¹

Stabilization clauses can be a useful tool to give investors certainty about the regulatory costs of their project or activities. Generally, they apply if the government *changes* some regulatory framework or rule in a manner that incurs a cost on the investor (or the government) greater than what was in place at the time of the contract.

This helps to assure the investor about the government’s support for the project, and can help them to plan ahead and make provisions for the crucial beginning phase of an investment. However, they can also cause problems, especially when:

- there is a significant change in the commercial or financial situation of the country or the government;
- an unforeseen impact on the environment, or on the health or safety of workers and communities arises;
- the government wishes to upgrade its regulatory framework, for example to provide for greater transparency and accountability;
- social unrest or disruption from the project requires a response from the government and/or the company.

We recommend that stabilization clauses should apply *only* to fiscal regulations, and only for a limited period of time.

There are mixed views about the usefulness of stabilization clauses, and about their enforceability under domestic and international law.⁴⁶² It may be argued that the commitments set out in Article 27.13 and 28.1 of the Model EPCC, or commitments of that type, are ineffective to restrain the Mozambican Government’s sovereign right to regulate as a matter of law.⁴⁶³ In any case, testing such a proposition would be an expensive and drawn-out exercise. For this reason, the revised petroleum legislation must take a cautious approach to providing stabilization guarantees, with a long-term perspective. We recommend that the legislation be amended to restrict the type of stabilization clause that can be included in any Concession Contract, and the duration of any contract.

Recommendation 60:

- Set out clear limits on stabilization clauses in the petroleum legislation so that they never extend to non-fiscal regulations, such as environment, health, or labor.
- Stabilization clauses should be limited to apply in respect of changes in the fiscal regime for the first five years of the project, and no longer.
- Stabilization clauses should either ensure that the fiscal regime agreed in the concession contract will remain in effect for the time period, or should provide for an “economic equilibrium”.

- If the stabilization clause provides for an “economic equilibrium”, the clause should require the concessionaire to mitigate the costs of compliance with the new fiscal regime and ensure that the cost of compliance is determined or verified by an independent expert before payment.

Access to facilities must be strengthened

Competition or antitrust law can play an important role in counteracting the commercial and political power of large companies. To be effective, however, it requires clear and sophisticated rules, a skilled regulator, and consistent enforcement. Given the challenges faced by Mozambique’s legal system, a truly effective competition law may be several years in the future. Yet, as the extractives industry quickly grows in size and influence, the need to curb unfair business practices and exploitation of market power will become crucial.

Article 19 of the Petroleum Law currently provides that the owner of a facility must provide access to a third party to use that facility on reasonable commercial terms. This is an important provision, which could help to improve the competitiveness and viability of Mozambique’s gas and petroleum production. In addition, as noted above, the Draft Petroleum Law gives the Government powers to determine the rules and approve contracts relating to third party access to infrastructure,⁴⁶⁴ to fix a methodology to calculate tariffs for such access, and approve the transfer of ownership of or right to use infrastructure.⁴⁶⁵ Nevertheless, in order to be effective and implementable, these access requirements should be strengthened with clear and detailed regulations. In particular, the new Article 20.3 of the Draft Petroleum Law states that any dispute between the owner of the infrastructure and a third party concerning the use of that infrastructure should be settled in accordance with regulations.⁴⁶⁶ Mozambique already has an example of effective access-sharing within the electricity industry, which it can draw on here.⁴⁶⁷

Recommendation 61: Amend the Petroleum Law to provide more specific obligations and guidelines about access to infrastructure. The legislation must ensure access to infrastructure on fair and reasonable terms to promote competition, increase efficiency, and accelerate the development of Mozambique’s extractive industry.

Penalties must be clear and significant to deter bad behavior

The Petroleum Law is lacking two important features to make it a strong and effective law. First, the obligations it places on concessionaires are vague and incomplete. As discussed above, many of the details of compliance have been left to regulations and to the concession contracts. Those details sometimes conflict with the overall purpose and general provisions of the Petroleum Act itself. Second, and related, the Petroleum Law lacks clear and significant penalties for a breach by the concessionaire. The draft petroleum law removes all existing provisions in relation to offences, and refers instead to regulations to be promulgated. Until these regulations are decided, the only “leverage” which the government has over a concessionaire is the threat to terminate a concession contract, and whatever penalties are set out in other legislation (such as environment or health and safety laws). The clarity and design of the penalty system will be crucial to ensuring that the new petroleum law is effective and workable.

Research has shown that the size of legal penalties imposed for a breach of environmental regulation is correlated to a loss in the market value of the offending company. Where penalties are small, shareholders pay little attention to the misconduct of the company.⁴⁶⁸ Thus, Mozambique cannot

depend on the “voice of the market” to discipline investors who have a bad environmental track record, and a slap on the wrist will not be enough to make shareholders (or management) pay attention. Ideally, the penalty should be so large that it is cheaper for the company to comply with the standards (and to take measures to prevent accidents) than it would be to pay the penalties. In other words, the company cannot decide to make an “efficient breach”. In addition, there should be substantial penalties for failing to report an accident or breach to the relevant government institution, or for providing false or misleading information about gas and petroleum operations.

Recommendation 62: Prescribe clear and significant penalties for breaches of the gas, petroleum and environmental legislation and regulations, including for breaches of reporting obligations.

Environmental protections must be strengthened

As discussed above, the draft petroleum law does provide that concessionaires will be liable for environmental harm and damage caused by petroleum operations, on a no fault basis. The legislation can go further than this, however, and ensure that management of extractives entities is personally liable for the acts and omissions of the company. As discussed in relation to mining, above, South Africa has provisions which hold directors of a company jointly and severally liable for the detrimental environmental impacts advertently or inadvertently caused by the company or its affiliates (*Section 6.2.1: Policy Recommendations to Clarify, Strengthen and Modernize the Existing Mining Legislation*).⁴⁶⁹ Such provisions are especially important as Mozambique expands its activities in a new area – natural gas.

Since most of Mozambique’s gas production is likely to occur offshore, it may be seen as a “cleaner” or “less disruptive” industry than mining. However, as discussed in *Section 4.3: Environmental Concerns in the Offshore Extractive Industry*, offshore natural gas production may still have significant and long-term environmental impacts. Seismic surveying may have detrimental effects on marine life, including fisheries. Floating production storage and offloading vessels, used to process and transport hydrocarbons, can carry risks of pollution. Drilling and production can also impact the marine environment, and emit “produced water” that contains carcinogenic pollutants. Once onshore, LNG facilities may also have serious environmental and health impacts for local communities.

One of the biggest challenges facing Mozambique in regulating its offshore natural gas production will be that its environmental and health impacts are still somewhat unknown. As a result, there are only a few jurisdictions that Mozambique can look to as “models” for regulation, and their laws may not cover all the risks. Rather than waiting for adverse effects or pollution to occur, and then enacting laws to hold companies accountable, the Government of Mozambique should take a “precautionary approach” and shift the burden of the unknown onto the companies themselves. This means that companies should be responsible for conducting baseline studies, taking appropriate care in their activities, monitoring the effects of their activities, and reporting to the Government. These provisions should be enforced by way of significant penalties and strict liability rules.

Recommendation 63: Shift the regulatory burden for environmental monitoring and reporting onto the companies. Ensure that penalties for environmental damage and pollution are significant enough to act as a deterrent. Hold companies strictly liable, and hold directors of the company jointly and severally liable for the actions or omissions of the company.

Holistic Resettlement Provisions must be included in the legislation

Although its impact is not likely to be as significant as for mining, private investors and government will require access to large areas of land in order to construct LNG facilities, and to develop the manufacturing industry that utilizes natural gas as an energy source. Inevitably, communities will be impacted by these developments – whether through the physical location of buildings and infrastructure, or through their environmental impacts. The draft petroleum legislation does require that some of the proceeds from petroleum operations be dedicated to the local community, nevertheless, that proportion has not yet been agreed on.⁴⁷⁰

A holistic approach to resettlement and compensation is essential to ensure that communities are adequately consulted and compensated for these impacts. Recommendations on how to improve the current regulatory framework for resettlement are discussed in further detail in *Section 6.2.1: Policy Recommendations to Clarify, Strengthen and Modernize the Existing Mining Legislation* and in *Section 5: Ensuring Social Equity in Extractive Industries-Based Development*.

Recommendation 64: Amend the existing Petroleum Law and the 2012 Resettlement Decree to provide greater protection of land occupancy rights of local communities who are forced to resettle due to gas and petroleum operations. Amendments include:

- Minimizing involuntary resettlement whenever possible;
- Gaining full and informed community consent by consulting with impacted communities, with particular attention being paid to women and other marginalized groups, at all stages of the resettlement process;
- Improving the impacted community's standard of living through livelihoods and by ensuring access to markets, education and healthcare facilities.
- Providing resettled communities with a share of future profits from mining operations.

Work with existing investors to renegotiate contracts in line with new regulations

Mozambique has already signed numerous concession contracts with companies to survey, explore and produce gas and petroleum. Assuming that each of these concession contracts contains a “stabilization clause” similar to that found in the Model EPCC, the government will not be able to change regulations affecting those companies without paying their compliance costs. Alternatively, the government could seek to agree with those companies that they will bring their operations into line.

Article 28 of the draft petroleum law sets out that existing contracts signed governing petroleum operations in Mozambique will be subject to the new regulations, except where the contract and the regulations conflict.⁴⁷¹ It is understandable that the government would hesitate to amend regulations in a way that might be contrary to the contractual provisions. However, this approach leaves significant gaps and differences in the regulatory framework for several mega-projects that are currently underway. Among these differences will be the concessionaires' liability for environmental damage and pollution. The government must attempt to work with existing holders of concession contracts to identify the conflicts between contracts and the new laws, and to agree on a plan to “bridge” those gaps.

Recommendation 65: Engage concessionaires to agree on a timeline and work program to bring their operations into line with the new environmental, health, labor, and other regulatory standards.

Archaeological Heritage Protection

History, culture, and archaeological heritage are an essential part of understanding a country's current society and values. It can help to generate understanding and national identity. For Mozambique, efforts to preserve and study archaeology became especially important following independence in 1975.⁴⁷²

There are numerous examples around the world of archaeological discoveries made by geologists and other workers during the first phases of extractives prospecting and exploration: ancient settlements, weapons and arms, tools, prehistoric bones, and so on. These discoveries have become so important that some operators now organize information seminars with the help of archaeologists prior to engaging in survey and exploration. Their objective is to inform workers and engineers about the history of their regions and on the emergency measures used to protect archaeological discoveries. When an ancient object or building is discovered, the authorities are always informed and meetings are usually organized with specialists to decide if a systematic excavation of the site is necessary or not. In some countries, the examination of an eventual "archaeological risk" is necessary during the Environmental Impact Assessment.⁴⁷³

Mozambique should take these steps into account when reviewing its Petroleum Law, to ensure that discoveries are reported, investigated and protected.

Recommendation 66: Include in the Petroleum Law an unconditional "stop work" order whenever a company finds archaeological materials. Appoint an independent agency to assess the finds and to delay work in the relevant area, and/or to approve continuance.

7.3.2 Reforming the Fiscal Regime for Gas and Petroleum

Tax revenue from extractive industries is the major potential benefit for Mozambique from gas, oil and mining. In its current review of the fiscal regime, the Government of Mozambique has been advised by donors, consultants, and by international organizations such as the IMF. Mozambique's existing fiscal arrangements for oil, gas and mining are discussed briefly in Section 1.2.2: Financing Liquefied Natural Gas Development, Section 6.2.1: Policy Recommendations to Clarify, Strengthen and Modernize the Existing Mining Legislation, and Section 7.1: Overview of the current Framework. We understand that a recent version of the draft oil and gas regime has been released for comment. The current draft regime appears to be a codification of the existing fiscal framework included in the Model EPCC – it incorporates a production tax, a corporate income tax, and a variable "production sharing" arrangement.

Rather than negotiating tax rates for each individual concession, this new regime will create a level playing field for investors. The Government should be commended for taking this important step towards providing certainty, clarity, and transparency. However, the new law doesn't go as far as it could. While its provisions need careful revision (to clarify definitions, tighten processes, and ensure that the tax base for each different component is reasonable), there also places where the regime could be simplified to improve its effectiveness. This section outlines some of the key considerations for Mozambique while reviewing its fiscal regime, in preparation for the next round of concession bidding.

Sunley, Baunsgaard and Simard, in a 2002 paper for the IMF, explained the objective of a fiscal regime:⁴⁷⁴

In designing fiscal instruments, the government will need to weigh its desire to maximize short-term revenue against any deterrent effects this may have on investment. This will require a balanced sharing of risk and reward between the investor and the government. The aim should be for fair and rising government share of the resource rent, without scaring off potential investors.

In a recent paper, the IMF set out the analytical framework that underpins its fiscal advice to specific countries.⁴⁷⁵ The paper emphasizes that a wide range of tools are used by different countries, but that on average, governments retain at least one third of mining revenue, and between 65-85% of gas and petroleum revenue. They state, that “[f]iscal regimes that raise less than these benchmark averages may be cause for concern, or – where agreements cannot reasonably be changed – regret. A share at the lower end of the scale may be appropriate if reserves have not yet been proven, since investors take on considerable risk in prospecting and exploration. However, now that Mozambique’s reserves have been established, it is appropriate for that share to increase.

One way to assess “fairness” is to benchmark the country’s fiscal regime against its peer group in the relative industry. This report does not include a detailed comparison of the government take in comparable jurisdictions – such analysis has already been carried out by the IMF.⁴⁷⁶ Their models found that Mozambique sat roughly in the middle of the range, with an average effective tax rate of almost 70% for an illustrative oil field project.⁴⁷⁷

However, such “benchmarking” is not always helpful. In Africa, extractive industries have been systemically under-taxed.⁴⁷⁸ Comparisons like these are retrospective – they cannot show what other countries might do in the future. And, as emphasized by the Vale Center in its report on Zambezi River Valley Development, the “government take”, in itself, is not enough to assess the fairness of a deal.⁴⁷⁹ The appropriate fiscal regime will depend on:

- The development needs of the country (which may demand front-loaded revenue to finance public investment);
- The political economy (which may affect the time value of revenue flows);
- The stage of development of the extractives industry (including whether there is sufficient competition);
- The value of the resources available;
- The method of extraction;
- The available infrastructure;
- The risk profile of the project; and
- The overall business environment of the country.

It is therefore useful for Mozambique to consider the range of tools available to tailor a fiscal regime that is appropriate for Mozambique, taking into account the current investment climate and the

country's development needs. In Appendix 1D: Fiscal Tools for Mining and Hydrocarbon Revenue we set out a basic outline of the key advantages and disadvantages of a range of different fiscal tools, including corporate income tax, capital gains tax, royalties, and bonuses. However, even with the ideal fiscal regime, Mozambique could risk losing millions of dollars worth of revenue each year without diligent oversight and transfer pricing controls.

Tackling Transfer Pricing – a gradual approach to regulation

As many extractives companies operate at different points of production (across the *value chain*) there are many opportunities for *transfer pricing*. That is, a company can artificially inflate or deflate the price of a good or service in order to make one arm of its business appear more or less profitable than it really is. In practice, this means that companies are able to show accounting “profits” in parts of the business that are subject to a lower tax rate, and show accounting “losses” in other parts of the business, subject to a higher tax rate. In this way, the company can pay far less tax worldwide than it would if it were transacting at *arms-length* in each jurisdiction. This lost revenue can have significant development impacts – particularly for countries with a low income tax base like Mozambique.⁴⁸⁰ In its recent report, the Africa Progress Panel estimated that, in Africa, around \$38.4 billion US is lost per year through trade mispricing, which it defines as “losses associated with misrepresentation of export and import values”.⁴⁸¹ This amounts to significantly more than the continent receives in FDI flows, at \$32.7 billion US.

- **One way to manage transfer pricing is to regulate *transfer prices***, and require that companies pay arms-length prices for goods and services provided by an affiliate. This is referred to as the **arms-length standard (ALS)**, and it is increasingly being adopted across Africa.⁴⁸² The OECD has agreed principles and methods for regulating transfer pricing in this way.⁴⁸³ However, this is a complex and expensive form of regulation.⁴⁸⁴ It requires time, resources, and expertise to monitor each company's affiliate transactions, and to determine the appropriate arms-length price for a wide range of goods and services. Sometimes the transactions between affiliates cannot easily be compared to a “market transaction”.⁴⁸⁵ In addition, these sorts of adjustments can undermine the efficiencies that motivate businesses to *invest* in a country and establish an affiliate in that jurisdiction.⁴⁸⁶
- **Mozambique's current transfer pricing law is weak:** The provision governing transfer pricing in Mozambique is contained in the Mozambican Corporate Income Tax Code (CIRPC, in Portuguese).⁴⁸⁷ This rule gives the Tax Administration Authority the right to make corrections for determining taxable profit when the transactions between related parties are not at arm's length.⁴⁸⁸ The application of this rule is very weak, with no implementation methods or special penalties for companies who engage in transfer pricing.⁴⁸⁹ One estimate suggests that Mozambique lost more than US\$ 23 million in tax revenue between 2005 and 2007 due to transfer pricing across its economy.⁴⁹⁰
- **An alternative, interim, approach is to cap the amounts that companies can claim for certain items:** In the long run, as its administrative capacity develops, Mozambique may choose to implement the OECD methods to manage transfer pricing. This will provide certainty for businesses operating across different jurisdictions, and will help to ensure that a fair share of tax is collected. In the meantime, Mozambique should consider a simpler method to manage transfer pricing, such as placing a cap on the amount that each country can claim for its “home office” expenses. This is the approach taken in the recent draft fiscal regime for oil and gas, although the precise rules need further detail to provide the necessary certainty.

Recommendation 67: Mozambique should take a phased approach to strengthening its current transfer pricing rules. First, a simplified mechanism should be imposed, such as a cap on intra-company costs for tax purposes. Second, the Government should work with the OECD and other international organizations or donors to formulate a comprehensive transfer pricing strategy that will help to ensure a fairer share of revenue for Mozambique.

7.3.3 International Investment Protection and Arbitration

Mozambique has made various international commitments to protect the investments of foreign companies and persons who choose to do business within its borders. These commitments come in a range of forms, but the most important are contained in international conventions (such as the ICSID Convention), international investment agreements (including bilateral investment agreements (*BITs*) and the investment provisions of some free trade agreements (*FTAs*)), and in contracts agreed directly with foreign investors, including concession contracts (*Investment Contracts*). While issues arising from Investment Contracts are broadly discussed above, this short section focuses on the standards of investment protection offered to investors, and to the form of dispute resolution most commonly preferred – investor-state arbitration.

International Centre for the Settlement of Investment Disputes

The International Centre for Settlement of Investment Disputes (*ICSID*) is an autonomous international institution that provides a forum and framework for the conciliation and arbitration of international investment disputes. Disputes may be brought to ICSID under the authority of an international investment agreement (such as a BIT or under the Investment provisions of an FTA), or in accordance with the provisions of an investment contract between a private party and a state relating to a particular project or activity.

Mozambique is Contracting State under the ICSID Convention, which means that it has agreed to be bound by the provisions of the ICSID Convention, Regulations and Rules. Its key features are:

- A dispute may be brought against a Contracting State by an individual or company that qualifies as a national of another ICSID Contracting State.
- Arbitration and conciliation under the Convention are **voluntary**, but once the parties have given their consent (in writing), neither party can withdraw without the other's consent.
- An arbitral award granted pursuant to the Convention may not be set aside by the courts of any Contracting State. All Contracting States (whether or not they are parties to the dispute itself) are required to recognize and enforce ICSID Convention arbitral awards in their domestic courts.

Concerns with Investor-State Dispute Settlement generally

As discussed above, concession contracts, and potentially other agreements concluded between Mozambique's government and individual investors, refer to ICSID arbitration as the required dispute settlement process for non technical matters. This raises several issues. In particular, the availability of investor-state dispute settlement (*ISDS*) within these agreements poses a restraint for domestic policy-making. As clearly outlined by Joachim Karl in a recent note, the increase in the number of investor-state disputes, along with the increasing complexity of those disputes, has led to an exponential increase in

the potential risks and costs of ISDS as a mechanism.⁴⁹¹ Even where a state can successfully defend a claim by an investor, the resources, time and cost of arbitration (as well as its potentially detrimental reputational effects) are significant. For this reason, the mere presence of BITs with ISDS provisions can have a “chilling” effect on government policy-making: if a proposed regulation could violate the investor protections included within a BIT, the government may be less likely to pursue that policy objective. This “deterrent” effect is positive when the regulation has “protectionist” intention (i.e. a policy that is designed to favor domestic producers or investors over foreign ones), but it has much broader influence (e.g. discouraging the adoption of a policy to introduce more stringent environmental or health standards). For example, recent and controversial disputes have arisen in relation to Australia’s laws for plain packaging of cigarettes, and threats have been made by investors to challenge South Africa’s “Black Economic Empowerment” policies.⁴⁹² As a result, both Australia and South Africa are moving away from the use of ISDS, and towards alternative mechanisms such as state-state dispute settlement (as is currently used for trade disputes in the WTO) or strengthened domestic remedies.

In other cases, successful claims by investors under BITs have led to significant monetary awards being made against states – For example, in the case of *CME v Czech Republic*, the arbitral tribunal awarded US\$ 269.8 million, plus 10% interest and costs, to the plaintiff;⁴⁹³ the (October 5, 2012) award in *Occidental v. Ecuador* of US\$1.76 bn (plus interest) is the highest to date. South American jurisdictions have borne the brunt of the large arbitral awards made since ISDS cases began to accelerate in the 1990s: It has been calculated that, as of February 2011, the sum of all awards against Argentina amounted to US\$ 430 million (after two committees had annulled awards amounting to over US\$ 200 million), with the country currently facing approximately \$US 65 billion in outstanding ICSID claims.⁴⁹⁴ There are concerns by some states, civil society, and by the public that the system (and the arbitrators appointed to decide disputes) has exhibited bias towards the investor in these decisions – and that not enough discretion has been allowed for states to pursue legitimate policy objectives.⁴⁹⁵

Responses and a way forward for Mozambique

Different states have responded to these concerns in different ways. Some, like Australia and South Africa, have focused on avoiding BITs or ISDS generally. In South America, there have been efforts to create a *regional* alternative to ICSID – a forum for resolution of investment disputes that would be based in, and governed by, members of UNASUR (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Peru, Paraguay, Suriname, Uruguay, and Venezuela). This would be a significant development, especially given that Brazil currently is not signatory to any BITs and does not consent to ISDS in any Investment Contracts.

Mozambique should consider aligning future negotiations for international investment agreements and domestic investment policy with sustainable development objectives, through using a tool such as UNCTAD’s *Investment Policy Framework for Sustainable Development*.⁴⁹⁶ In particular, Mozambique should consider:

- removing investor-state dispute settlement from its BITs, and favoring state-state dispute settlement mechanisms;
- providing clear policy space for regulation relating to environment, health, social impacts, human rights, and resource management;
- reserving the highest levels of investor protection for only those investors who meet certain criteria of sustainable practices, and corporate social responsibility.

Notes to Section 7

⁴⁰⁸ Jenik Radon, Esq., Laixa Lizardo, Samira Nikaein, Christine Lio Capilouto, Esq. and Dionisio Nombora, “Comment Letter on the Revision of the Petroleum Legislation of Mozambique,” Maputo, Mozambique, June 19, 2012.

⁴⁰⁹ Freshfields Bruckhaus Deringer LLP, March 2013, “Mozambique” Couto, Graca and Associates:

http://www.freshfields.com/uploadedFiles/SiteWide/News_Room/Insight/Africa_ENR/Mozambique/Mozambique%20oil%20and%20gas.pdf

⁴¹⁰ The “territorial sea” includes waters of 12 nautical miles, measured from the baseline.

⁴¹¹ Further details on the types of contracts available are set out in Appendix 1C.

⁴¹² A company is a “Mozambican legal entity” if more than 50% of its share capital is held by another Mozambican legal entity.

⁴¹³ This obligation applies where all relevant features of the application (or bid) are the same.

⁴¹⁴ The functions and activities of ENH are discussed in *Section 8*.

⁴¹⁵ The Petroleum Law provides that royalties shall be set between 2-15%, and the precise level of the royalty must be decided by the Council of Ministers (Article 25).

⁴¹⁶ Petroleum Tax Law, see *Appendix 1B* for details of relevant laws and regulations.

⁴¹⁷ The requirement to prepare and submit a Development Plan following a commercial discovery is set out in the Petroleum Law, Article 17(c).

⁴¹⁸ Fiscal Incentives Law, see *Appendix 1B*. The benefits are transferable while in force, with the approval of the Minister of Finance.

⁴¹⁹ Corporate income tax is payable by the concessionaire(s) at the rate of 32 per cent of net profit. Under the Model EPCC, deductions can be made for depreciation from the later of the year an expenditure is made and the year commercial production starts, at a rate of 100% for exploration and 25 % for development and production expenditures. Losses may be carried forward for up to five years.

⁴²⁰ Petroleum Law, Article 17(g). No additional guidance is given on how this “competitiveness” should be measured or benchmarked.

⁴²¹ Local Content is discussed in more detail in *Section 2*.

⁴²² Model EPCC, Article 18.2. This provision sets out that the concessionaire “shall endeavour to utilise citizens of the Republic of Mozambique having appropriate qualifications to the maximum extent possible at all levels of its organisation, as Sub-Contractors or employed by Sub-Contractors.” The concessionaire is required to consult with MIREM and propose and carry out an “effective training and employment programme for its Mozambican employees in each phase and level of operations, taking account of the requirements of safety and the need to maintain reasonable standards of efficiency in the conduct of the Petroleum Operations.”

⁴²³ *Ibid.*, Article 18.

⁴²⁴ Petroleum Law, Article 5(2).

⁴²⁵ Regulations for resource management, safety, health and environmental protection may also be drafted and are approved by the Council of Ministers, Petroleum Law, Article 28(1)(b).

⁴²⁶ Petroleum Law, Article 23(1)(a)-(g).

⁴²⁷ *Ibid.*, Article 23(1)(a).

⁴²⁸ The seat of arbitration is negotiable and Mozambican law applies.

⁴²⁹ Lise Johnson, “Case Note: How Chevron v Ecuador is Pushing the Boundaries of Arbitral Authority” *Investment Treaty News*, April 13, 2012: <http://www.iisd.org/itn/2012/04/13/case-note-how-chevron-v-ecuador-is-pushing-the-boundaries-of-arbitral-authority/>.

⁴³⁰ The Secretary General of ICSID, Meg Kinnear, has argued that an analysis of the disputes brought to and decided by arbitration panels actually show that they have found in favor of state parties in just over 50% of cases. Meg Kinnear “The Present and Future Challenges of ICSID” (January 31, 2013) Presentation at the Vale Columbia Center for Sustainable International Investment, Columbia University, New York.

⁴³¹ Robert Howse, “Freezing Government Policy: Stabilization Clauses in Investment Contracts” *Investment Treaty News*, April 4, 2011: <http://www.iisd.org/itn/2011/04/04/freezing-government-policy-stabilization-clauses-in-investment-contracts-2/>.

⁴³² Petroleum Regulations, Article 5(1).

⁴³³ *Ibid.*, Article 5(3).

⁴³⁴ The time period for that confidentiality is three years for Survey Concession Contracts, but no time limit is set for Exploration and Production or Oil or Gas Pipeline Concession Contracts, see Petroleum Regulations, Article 5(2).

⁴³⁵ “Mozambique: Calls for Parliament to Debate Freedom of Information” *All Africa*, October 1, 2012, <http://allafrica.com/stories/201210020206.html> (accessed April 28, 2013).

⁴³⁶ Mexico’s law is the Lalanath de Silva, “Freedom of Information Laws Spreading Around the World” (September 26, 2010).

⁴³⁷ National Security Archive, “Mexico Freedom of Information Program”:

<http://www.gwu.edu/~nsarchiv/mexico/transparency.htm>.

⁴³⁸ See, for example, the New Zealand *Official Information Act 1982*, section 9(2)(b)(ii).

⁴³⁹ Petroleum Regulations, Article 23.3(f).

⁴⁴⁰ “Mozambique Cabinet Backs Oil Law” *Business Report* (April 10, 2013):

<http://www.iol.co.za/business/international/mozambique-cabinet-backs-oil-law-1.1498179#.UZKVqCvwlwx>.

⁴⁴¹ Lei do Imposto sobre Producao Petroleo Lei 12 de Junho de 2007.

⁴⁴² Danielle Beggs, David Tennant and Humphrey Douglas. “Mozambique petroleum update,” (February 11, 2013) *Lexology*:

<http://www.lexology.com/library/detail.aspx?g=aaffa7d9-63f8-42df-9263-826d0c25a1f8>.

⁴⁴³ “Mozambique Cabinet Backs Oil Law” *Business Report* (April 10, 2013):

<http://www.iol.co.za/business/international/mozambique-cabinet-backs-oil-law-1.1498179#.UZKVqCvwlwx>.

⁴⁴⁴ Draft Petroleum Law, Article 11(d).

⁴⁴⁵ *Ibid.*, Article 18(d).

⁴⁴⁶ *Ibid.*, Article 18(b).

⁴⁴⁷ *Ibid.*, Article 9.2.

⁴⁴⁸ *Ibid.*, Article 9.3.

⁴⁴⁹ Draft Petroleum Law, Article 7.2, and Article 7.3. William Felimao & Paul Burkhardt, “Mozambique Cabinet Backs Oil Law That Clarifies Investor Rules” *Bloomberg* (April 10, 2013) available at: <http://www.bloomberg.com/news/2013-04-10/mozambique-cabinet-backs-oil-law-that-clarifies-investor-rules.html>.

⁴⁵⁰ Draft Petroleum Law, Article 10(i), (“Compete ao Governo: ... (i) determinar as regras, aprovar os contratos relativos ao acesso de terceiros às infra-estruturas e a metodologia para a fixação de tarifas”).

⁴⁵¹ *Ibid.*, Article 10 (“Compete ao Governo: ... (m) Aprovar a transmissão da propriedade das infra-estruturas ou o direito de uso de infra-estruturas”).

⁴⁵² *Ibid.*, Article 18. <http://www.bernama.com.my/bernama/v7/wn/newsworld.php?id=941119>

⁴⁵³ *Ibid.*, Article 23.4 (“O titular do direito de exercício de operações petrolíferas que, por força do exercício dos seus direitos na área abrangida pelo contrato, cause danos às culturas, solos, construções, equipamentos ou benfeitorias incorre na obrigação de indemnizar os titulares dos referidos bens nos termos da legislação aplicável.”) Note that a similar provision is included in Article 27.7 of the Model EPCC.

⁴⁵⁴ *Ibid.*, Article 23.5 (“Se as operações petrolíferas, causarem dano ambiental ou poluição, o titular de direitos para o exercício de operações petrolíferas, incorre na obrigação de indemnizar a parte afectada pelo prejuízo ou dano causado, independentemente da culpa.”).

⁴⁵⁵ Beggs et. al., 2013.

⁴⁵⁶ World Bank *Regulation of associated gas flaring and venting: a global overview and lessons from international experience*. Global gas flaring reduction - a public-private partnership: No. 3. Washington D.C. - The Worldbank, 2004: <http://documents.worldbank.org/curated/en/2004/04/4946514/regulation-associated-gas-flaring-venting-global-overview-lessons-international-experience>.

⁴⁵⁷ *Ibid.* 6. Joe Gurowsky “Gas Flaring back in the Spotlight” November 9, 2012, available at: <http://foreignpolicyblogs.com/2012/11/09/gas-flaring-back-in-the-spotlight/>.

⁴⁵⁸ John Mark Keyes, “Incorporation by Reference in Legislation” *Statute Law Review* 25(3), (2004), 180-195.

⁴⁵⁹ For a good outline of these approaches, and sample legislative wording, see *Ibid.*

⁴⁶⁰ Model EPCC, Article 27.13.

⁴⁶¹ Article 28.1 of the Model EPCC states: “The Government will at all times during the life of the Petroleum Operations ensure in accordance with this Article, that measures taken in the interest of safety, health, welfare or the protection of the environment are in accordance with standards generally accepted from time to time in the international petroleum industry and are not unreasonable.”

⁴⁶² See, for example: David Clinch and James Watson “Stabilisation clauses – issues and trends” (Herbert Smith Freehills, 2010) available at: <http://www.lexology.com/library/detail.aspx?g=c5976193-1acd-4082-b9e7-87c0414b5328>; Piero Bernadini “Stabilization and adaptation in oil and gas investments” 1 *Journal of World Energy Law and Business* (2008) 98-112.

⁴⁶³ *Ibid.* See also the discussion in Margarita T.B. Coale, “Stabilization Clauses in International Petroleum Contracts” 30 *Denver Journal of International Law and Policy* (2001-2002), 217.

⁴⁶⁴ Draft Petroleum Law, Article 10(i), (“Compete ao Governo: ... (i) determinar as regras, aprovar os contratos relativos ao acesso de terceiros às infra-estruturas e a metodologia para a fixação de tarifas”).

⁴⁶⁵ *Ibid.*, Article 10 (“Compete ao Governo: ... (m) Aprovar a transmissão da propriedade das infra-estruturas ou o direito de uso de infra-estruturas”).

⁴⁶⁶ *Ibid.*, Article 20.3 (“Qualquer disputa entre o proprietário da infra-estrutura ou o titular do direito do uso da infra-estrutura ao abrigo da Lei e terceiros, relativo ao uso da infra-estrutura, será resolvida nos termos a regulamentar.”)

⁴⁶⁷ Based on discussions with stakeholders in Mozambique.

⁴⁶⁸ Jonathan M Karpoff, John R Lott, and Graeme Rankine, “Environmental Violations, Legal Penalties, and Reputation Costs” The Law School, The University of Chicago, Working Paper available at: http://www.law.uchicago.edu/files/files/71.Lott_Environment.pdf.

⁴⁶⁹ South Africa Mineral and Petroleum Resources Act of 2002, section 38(2).

⁴⁷⁰ Draft Petroleum Law, Article 7.2, and Article 7.3.

⁴⁷¹ *Ibid.*, Article 28 (“Os direitos adquiridos ao abrigo de contratos e contratos de concessão em execução celebrados ao abrigo da Lei n.º 3/2001, de 21 de Fevereiro, relativos às operações petrolíferas continuam válidos, passando a ser regidos pela presente lei, em tudo o que não contrarie o clausulado contratualmente.”).

⁴⁷² PJJ Sinclair, JMF Morais, L Adamcowicz & RT Duarte, “A perspective on archaeological research in Mozambique” in Thurstan Shaw, ed., *Archaeology of Africa: Foods, Metals and Towns* (Routledge, 1993) 409.

⁴⁷³ Dr. F. Brodkum, *Good Environmental Practice in the European Extractive Industry: A Reference Guide*, (Belgium: 2000).

⁴⁷⁴ Emil M. Sunley, Thomas Baunsgaard and Dominique Simard “Revenue from the Oil and Gas Sector: Issues and Country Experience” Background paper prepared for the IMF conference on fiscal policy formulation and implementation in oil producing countries, June 5-6, 2002. Post-conference draft, (June 8, 2002), 1.

⁴⁷⁵ IMF *Fiscal Regimes for Extractive Industries: Design and Implementation* (August 15, 2012) 27.

⁴⁷⁶ *Ibid.*

⁴⁷⁷ *Ibid.*

⁴⁷⁸ Africa Progress Panel *Africa Progress Report 2013: Equity in Extractives* (2013) available at: <http://www.africaprogresspanel.org/en/publications/africa-progress-report-2013/apr-documents/>.

⁴⁷⁹ Lisa Sachs, Perrine Toledo and Susan Maples. “Resource-Based Sustainable Development in the Lower Zambezi Basin: A draft for consultation,” (New York: VCC, 2011).

⁴⁸⁰ For a discussion of the development impacts of transfer pricing, see the following article by the UN Assistant Secretary-General for Economic Development: Jomo Kwame Sundaram, “Transfer Pricing is a Financing for Development Issue” February 2012, (Friedrich Ebert Stiftung): http://www.globalpolicy.org/images/pdfs/Jomo_-_Transfer_Pricing.pdf, 1.

⁴⁸¹ Africa Progress Panel, 2013.

⁴⁸² PWC has prepared a report on the transfer pricing landscape in Africa, which discusses the spread of ALS regulation. Anthony Curtis & Ogniana Todorova, *Spotlight on Africa’s Transfer Pricing Landscape*, Transfer Pricing Perspectives: Special edition (PWC) available at: <http://www.pwc.com/gx/en/tax/transfer-pricing/management-strategy/assets/pwc-transfer-pricing-africa.pdf>.

⁴⁸³ OECD Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations (2010, Paris).

⁴⁸⁴ See Sundaram, 2012.

⁴⁸⁵ For example, when one affiliate pays another for the use of intangible property, like intellectual property rights. See Sundaram, 2012, 4.

⁴⁸⁶ Companies now locate different parts of the value chain in different jurisdictions, seeking different types of efficiency (e.g. access to markets, labor, resources or technology).

⁴⁸⁷ Article 49 of the CIRPC provides that adjustments may be made when, “by virtue of special relations between the taxpayer and the other entity, different conditions were established from those that would normally be agreed between independent entities resulting in non-arm’s length profits.” Article 52.2 sets out when “special relations” may exist between a resident and non-resident entity. See discussion in PWC, op. cit., at 19.

⁴⁸⁸ The CIRPC does not set out any regulations on implementation or methods for calculating what is an arm’s length transaction, see PWC, 19.

⁴⁸⁹ PWC, 19; see also Sachs et. al., 2011, reporting comments of accountants in Maputo at 129.

⁴⁹⁰ McCaughey, Sorley. *Tax of Life: How Tax Dodging Undermines Irish Support to Poor Nations*. Christian Aid (May 2010), cited in Sachs et. al., 2011, at 129.

⁴⁹¹ Joachim Karl, “Investor-state dispute settlement: A government’s dilemma” *Columbia FDI Perspectives* (: Vale Columbia Center for Sustainable International Investment, February 12, 2013)

⁴⁹² IIAPP (2011) *Foresti v South Africa* (Italy-South Africa BIT), available at: http://iiapp.org/media/uploads/foresti_v_south_africa.rev.pdf discussed in CEO & TNI *Profiting from Injustice* (2012), 13, available at: www.tni.org/profitfrominjustice.pdf.

⁴⁹³ *CME v. Czech Republic*, Final Award, March 14, 2003, available at: http://italaw.com/documents/CME-2003-Final_001.pdf, 161, paras. 1-2. On May 16, 2003, the Czech Republic paid the amount awarded. Peter S. Green, “Czech Republic Pays \$355 Million to Media Concern,” *New York Times*, May 16, 2003, available at: <http://www.nytimes.com/2003/05/16/business/czech-republic-pays-355-million-to-media-concern.html>.

⁴⁹⁴ Luke Eric Peterson, “Argentina by the Numbers: Where Things Stand with Investment Treaty Claims Arising Out of the Argentine Financial Crisis,” *International Arbitration Reporter*, 1 February 2011: http://www.iareporter.com/articles/20110201_9; “Argentina Faces 65bn Dollars in Claims; Plans to Abandon International Litigations Court,” *Mercopress*, November 28, 2012: <http://en.mercopress.com/2012/11/28/argentina-faces-65bn-dollars-in-claims-plans-to-abandon-international-litigations-court>. It should be noted, though, that tribunals seldom award the full amount to claimants even when arbitration claims are successful.

⁴⁹⁵ George Kahale, III summarized the issue as follows: “In truth, the problem goes beyond the question of whether bias in the system actually exists. On this issue, perception matters as much as reality. States are not likely to continue to play in a game they sense, justifiably or not, is rigged against them. Since it takes two to tango, the growing dissatisfaction of states with the international arbitral process looms as a major problem in investor/state relations and requires a critical assessment of the future of international arbitration as a means of settling investment disputes.” George Kahale, III, “A Problem in Investor/State Arbitration,” 6(1) *Transnational Dispute Management* (2009), 1.

⁴⁹⁶ UNCTAD, *Investment Policy Framework for Sustainable Development* (New York and Geneva: UNCTAD, 2012).



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